Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

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Related Bills:	See Legislative History	Telephone:	845-5683	Introduced Date:	February 27, 2009
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Sales and Use Tax Paid For Qualified Renewable Energy Production Property Used In Enterprise Zone, Targeted Tax Area, Or Local Military Base Realignment Area Credit

SUMMARY

This bill would allow a tax credit equal to 100 percent of the sales or use tax paid to acquire property used to produce or generate renewable energy, as specified.

PURPOSE OF THE BILL

The legislative findings in the bill indicate that the purpose of the bill is to increase investment in cleantech activity and attract additional investment capital, clean industry, and high paying jobs to the state.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective immediately upon enactment and specifically operative for taxable years beginning on or after January 1, 2009, and before January 1, 2016.

POSITION

Pending.

ANALYSIS

FEDERAL/STATE LAW

Existing state and federal laws provide various tax credits designed to provide tax relief for taxpayers who incur certain expenses (e.g., child adoption) or to influence behavior, including business practices and decisions (e.g., research credits or economic development area hiring credits). These credits generally are designed to provide incentives for taxpayers to perform various actions or activities that they may not otherwise undertake.

Board Position:			Department Director	Date
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Federal Law

Federal law currently provides two energy-related credits: an energy credit that is one portion of the investment credit and a business credit for the production of electricity from certain renewable resources.

The energy investment credit is equal to 10 percent of the basis of energy property placed in service during the taxable year. Energy property includes equipment that uses solar energy to generate electricity, to heat or cool a structure, or to provide solar process heat. It also includes equipment that produces, distributes, or uses energy derived from geothermal deposits. The equipment also must meet performance and quality standards prescribed by federal regulations.

The business credit for the production of electricity from certain renewable resources is equal to 1.5 cents multiplied by the kilowatt hours of electricity produced by the taxpayer from qualified energy resources at a qualified facility. To qualify for the credit the electricity is required to be sold to an unrelated person during the taxable year. Qualified energy resources include wind, closed-loop biomass, and poultry waste.

State Law

Under the Government Code, existing state law provides for the designation of enterprise zones (EZ), Local Agency Military Base Recovery Areas (LAMBRA), a Targeted Tax Area (TTA), and two Manufacturing Enhancement Areas (MEA). Using specified criteria, the Technology and Trade and Commerce Agency (TTCA) designates these economic development areas from the applications received from the governing bodies. EZs are designated for 15 years (except EZs meeting certain criteria may be extended to 20 years), and TTCA is authorized to designate 42 EZs under current law (as of May 10, 2007, 42 EZs have been designated).[1] However, when an EZ expires, TTCA is authorized to designate another in its place. Eight LAMBRA designations are authorized, at least one from each of the five regions (as specified) of the state. Currently, TTCA has designated six of the eight LAMBRAs and one other area has received conditional designation. Each LAMBRA designation is binding for eight years. The TTA was designated November 1, 1998, and the MEAs were designated October 1, 1998. Both the TTA and MEAs are binding for 15 years beginning January 1, 1998.

TTCA may audit EZ programs and determine a result of superior, pass, or fail, and may dedesignate failing programs. Any business located in a dedesignated zone that has elected to avail itself of any state tax incentive for any taxable year prior to dedesignation may continue to avail itself of those tax incentives for a period equal to the remaining life of the EZ, provided the business otherwise is still eligible for those incentives. Once an EZ is dedesignated, it is no longer an EZ for designation purposes. Thus, once an EZ is dedesignated, TTCA may designate another EZ in its place to maintain a total of 42 EZs.

Under the Revenue and Taxation Code, existing state law provides special tax incentives for taxpayers conducting business activities within economic development areas. These incentives include a sales or use tax credit as discussed in greater detail below.

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[1] http://www.hcd.ca.gov/fa/cdbg/ez/Enterprise_Zone_map.pdf

Sales or Use Tax Credit

The sales or use tax credit is allowed for an amount equal to the sales or use taxes paid on the purchase of qualified machinery purchased for exclusive use in an economic development area (except a Manufacturing Enhancement Area). The amount of the credit is limited to the tax attributable to economic development area income. Qualified property is defined as follows:

Enterprise Zone or TTA:

- machinery and machinery parts used for:
    - manufacturing, processing, assembling, or fabricating;
    - producing renewable energy resources; or
    - air or water pollution control mechanisms.
- data processing and communication equipment.
- certain motion picture manufacturing equipment.

LAMBRA:

- high-technology equipment (e.g., computers);
- aircraft maintenance equipment;
- aircraft components; or
- certain depreciable property.

In addition, qualified property must be purchased and placed in service before the economic development area designation expires. The maximum value of property that may be eligible for the EZ, LAMBRA, and TTA sales or use tax credit is $1 million for individuals and $20 million for corporations.

Apportioning

For businesses operating inside and outside an economic development area, the amount of credit that may be claimed is limited by the amount of tax on income attributable to the economic development area. Income is first apportioned to California using the same formula as that used by all businesses that operate inside and outside the state (property, payroll, a double-weighted sales factor; for taxable years beginning on or after January 1, 2011, certain corporations may elect to use a single factor, 100 percent sales apportionment formula). This income is further apportioned to the economic development area using a two-factor formula based on the property and payroll of the business.

Total business credits are limited to 50 percent of a specified amount for taxable years beginning on or after January 1, 2008, and before January 1, 2010 for taxpayers with net “business income” under the Personal Income Tax Law (PITL) or income subject to tax under the Corporate Tax Law (CTL) of $500,000 or more. Under PITL, “business income” means income from a trade or business (including partnerships and S corporations), rental activities, and a farming business. The carryover period for any amounts in excess of the specified limitation is extended for the number of taxable years that the credit was not allowed.

Corporate taxpayers who are members of a combined reporting group may make a one time, irrevocable assignment of eligible credits, as defined, to an eligible assignee, as defined. Assigned credits can reduce tax for taxable years beginning on or after January 1, 2010.

THIS BILL

This bill would allow a credit under the PITL and the CTL equal to the sales or use tax paid by a taxpayer to purchase “qualified property”.

This bill defines “qualified property” as any property used in an EZ, TTA, or a LAMBRA for the production or generation of renewable energy.

This bill would allow any unused credit to be carried forward for a maximum of five years or until exhausted, whichever comes first.

This credit would be repealed as of December 1, 2016.

IMPLEMENTATION CONSIDERATIONS

The department has identified the following implementation concerns. Department staff is working with the author’s office to resolve these and other concerns that may be identified.

1. This bill uses the undefined term “production or generation of renewable energy.” The absence of a definition to clarify this term could lead to disputes with taxpayers and would complicate the administration of this credit.

2. Additionally, department staff does not have expertise in the production or generation of renewable energy. Typically, credits involving areas for which the department lacks expertise are certified by another agency or agencies that possess the relevant expertise. The certification language would specify the responsibilities of both the certifying agency and the taxpayer. The taxpayer could then be required to provide this certification to FTB upon request.

3. This bill defines “qualified property” as any property that is used in an EZ, TTA, or LAMBRA for the production or generation of renewable energy. This definition is broad and would be subject to different interpretations; for example, an argument could be made that the sales or use tax paid on the purchase of all tangible goods used in a designated zone for the production or generation of renewable energy would qualify as a credit amount. If it is the author’s intent to encourage investment in the cleantech industry, the author may wish to amend this bill to clarify the definitions of “qualified property.”

4. This bill is silent on the level of use "for the production or generation of renewable energy" that is required for a purchase to qualify for the credit. This could lead to disputes between the department and taxpayers. The author may wish to amend this bill to clarify the level of use necessary for a purchase to qualify for the credit to ease administration of this credit.

5. This bill fails to state whether the zone designation must be in effect at the time the purchases are made in order to qualify for the credit. This may lead to disputes between the department and taxpayers. If it is the author's wish to provide an incentive for increasing renewable energy production or generation within an active zone, the author may wish to amend this bill.

6. This bill fails to include a recapture provision. It is possible that a taxpayer could purchase the property, claim the credit, and either return the property, or resell the property to a third party that may also claim the credit. If this bill were to require that the property be placed in service in an EZ, TTA, or LAMBRA located in California, with an appropriate recapture provision to ensure continued operation in California for a specified (recapture) period, this potential problem would be avoided. The recapture provision would require the taxpayer to use the equipment for a certain length of time in the designated areas in this state or add all or some portion of the credit amount back to the tax liability.

7. Existing law allows taxpayers a credit for sales and use tax paid on qualified property placed in service in an EZ or TTA that is, "Machinery and machinery parts used for the production of renewable energy resources." It is unclear whether this bill provides a credit that does not already exist to taxpayers located in an EZ or TTA. If it is the author's intent to allow producers and generators of renewable energy to aggregate all zone credits and apply the aggregated credit against the total income earned within an EZ, TTA, or LAMBRA, the author may wish to amend the existing code sections for the EZ, TTA, and LAMBRA sales and use tax credit.

8. This bill would allow a credit for "an amount equal to the sales and use tax paid or incurred. "California has many special taxing jurisdictions (districts), which are funded by a transactions (sales) and use tax rate that is added to the standard statewide rate of 8.25 percent.[2] The tax rates for these districts range from 0.10 percent to 1.00 percent per district. In some areas, there is more than one district tax in effect. In others, there is no district tax in effect. It is unclear whether the credit would be equal to the standard statewide rate or the statewide rate plus the district rate and how any required reimbursements would occur. The author may wish to amend this bill for clarification.

[2] The statewide sales and use tax rate of 8.25 percent is effective as of April 1, 2009.

LEGISLATIVE HISTORY

AB 1452 (Committee on Budget, Stats. 2008, Ch. 763) limited the allowable business tax credit for a taxpayer with "net business income" (PITL) or income subject to tax (CTL) equal to or greater than $500,000 to a specified amount. The limitation applies to taxable years beginning on or after January 1, 2008, and before January 1, 2010. AB 1452 also allows a corporate taxpayer to make a one time, irrevocable assignment of certain credits to an affiliated corporation, as defined, for taxable years beginning on or after July 1, 2008. Assigned credits can not reduce tax for taxable years beginning before January 1, 2010.

SBX3 15 (Calderon, Stats. 2009, Ch. 17), among other things, allows certain taxpayers to elect to use a single factor 100 percent sales apportionment formula for taxable years beginning on or after January 1, 2011.

AB 1527 (Arambula, 2007/2008) would have allowed a credit for research conducted in California that is dedicated to the development of cleantech technologies for taxable years beginning on or after January 1, 2009. This "qualified clean tech research credit" would have been allowed in addition to the current California research credit. AB 1527 failed to pass out of the first house by the constitutional deadline.

SB 200 (Kelley, Stats. 1997, Ch. 609) made various technical changes to the credits allowed under the Enterprise Zone Act, and AB 2798 (Machado, Stats. 1998, Ch. 323) clarified the EZ incentive calculation for apportioning corporations.

SB 2023 (Costa, Stats. 1996, Ch. 955), the Enterprise Zone Act, among other things, allowed a credit for sales and use tax paid by a taxpayer for qualified property placed into service in a California EZ.

OTHER STATES' INFORMATION

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York.* These states were selected due to their similarities to California's economy, business entity types, and tax laws.

Florida allows corporate taxpayers to claim a corporate income tax credit for tax years beginning on or after January 1, 2007, for certain "eligible costs" for renewable energy technologies investments in *Florida*. The credit incurred by an affiliated corporation may be used to reduce the tax imposed upon the consolidated group. Additionally, the credit may be transferred to a surviving or acquiring entity after a merger or acquisition. *Florida* has no comparable credit for personal income taxpayers because *Florida* has no state personal income tax.

Michigan allows corporate taxpayers to claim a credit, as specified, against the *Michigan* business tax for research, development, or manufacturing of an alternative energy marine propulsion system, an alternative energy system, an alternative energy vehicle, alternative energy technology, or renewable fuel performed in *Michigan*.

Illinois, Massachusetts, Minnesota, and *New York* laws do not provide a credit comparable to the credit that would be allowed by this bill. Generally, these states provide an exemption from sales or use tax for purchases of manufacturing machinery and equipment.

FISCAL IMPACT

If the implementation considerations addressed in this analysis are resolved, the department's costs are expected to be minor.

ECONOMIC IMPACT

Revenue Estimate

This bill would result in the following revenue losses:

Estimated Revenue Impact of AB 1159 as introduced on 2/27/09 For taxable years beginning on or after 1/1/09 Enactment Assumed After 6/30/09 ($ in Millions)			
Fiscal Year	2009-10	2010-11	2011-12
Revenue Loss	-$2.3	-$2.8	-$3.5

This analysis does not consider the possible changes in investment activity, employment, personal income, or gross state product that could result from this bill.

Revenue Discussion

The revenue impact of this bill would depend on the cost of qualified property purchased annually, beginning on January 1, 2009, that is subject to sales or use tax, the rate of sales or use tax paid on these purchases, and the amount of generated credits that could be applied to reduce the tax liability for any given year.

This estimate assumes that the credit would apply to qualified property used in an EZ, TTA, or LAMBRA located in California.

In a revenue estimate prepared by the Board of Equalization (BOE) for a bill that would have exempted property used in the production or generation of renewable energy from sales and use tax, it was determined that exempted property purchases in 2001 amounted to $83 million statewide. Given an estimated $147 billion in taxable purchases by all businesses (non-individuals) in California in 2001, purchases of qualified renewable energy property was approximately 0.056 percent of all taxable business purchases, $83 million / $147 billion ≈ 0.056%. This percentage is then grossed-up 565 percent to 0.318 percent to account for a number of factors that include:

- growth in the popularity of renewable energy over and above the general growth in the economy.
- additional investment due to the incentive that would be offered by this bill.
- technological advances.
- expansion of the definition of "qualified property" in this bill relative to the more narrowly defined term that was used in the BOE's analysis.

Next the volume of purchases that would occur within the designated EDAs for purposes of this bill is estimated**.** Based on 2007 data from BOE and departmental data on qualified property for the EZ sales and use tax credit under current law, 4.83 percent of all business purchases subject to sales or use tax occurred within an EZ area. Based on departmental data, this percentage is then grossed-up 106.3 percent to 5.13 percent, 4.83% x 106.3% = 5.13%, to reflect the application of the proposed credit to purchases of equipment used in the zones specified in this bill: EZ, TTA, or LAMBRA. For purposes of this estimate it is assumed that the ratio of purchases made in the specified zones to state-wide purchases remained at 5.13 percent.

Combining the percentages derived in the above two paragraphs suggests that an estimated 0.0163 percent, 0.318% x 5.13% = 0.0163%, of all taxable business purchases are for renewable energy production or generation property by businesses with operations in an EZ, TTA or LAMBRA. Using this estimated percentage of qualified purchases, it is estimated that purchases of renewable energy production property for 2008 totaled approximately $30.5 million, $187 billion in taxable business purchases in 2007 per BOE x 0.0163% qualified property factor ≈ $30.5 million.

For tax year 2009, qualified renewable energy property purchases under this bill includes a 10 percent estimated annual growth rate in cleantech investments, thus the 2009 purchases total approximately $33.6 million, $30.5 million x 110% ≈ $33.6 million. Assuming a 9 percent average sales tax rate yields total potential credits generated of approximately $3 million, $33.6 million x 9% ≈ $3 million.

For purposes of this estimate it is assumed that 60 percent of the generated credits are applied in the year generated and that unused credits are applied ratably over a five-year period. For example, the applied credit for 2009 would be approximately $1.8 million, $3 million x 60% ≈ $1.8 million, with the remaining credit of approximately $1.2 million spread to the subsequent five years and applied at a rate of approximately $240,000 per year, $1.2 million/5 ≈ $240,000.

Taxable year estimates are then converted to fiscal year cash flows as presented in the above table.

This estimate assumes that purchases of energy-<u>efficient</u> property, such as products with Energy Star certification, would not qualify for the credit. Also, this estimate does not include any revenue loss from the purchase of property to build a new renewable-energy-producing facility, such as a geothermal or solar plant operated by a utility because no information on planned new facilities to be located in an economic development area was identified. As an example, using the methodology described above and assuming a scenario where currently unidentified planned new facilities purchased $100 million of tangible personal property that would be eligible for this credit, the resulting tax credit allowed would increase, resulting in an additional estimated revenue loss that varies from $7.25 million to $9.25 million, depending upon the timing of these purchases and the sales or use tax rate applied.

ARGUMENTS/POLICY CONCERNS

This bill fails to state whether the EZ, TTA, or LAMBRA must be located within California. This could result in taxpayers claiming a credit on equipment used in a zone located outside of California. If it is the author's intent that the benefits of this credit result from activity in California, the author may wish to amend this bill.

The credit would be allowed for sales and use tax expenses paid or incurred either inside or outside California. However, it is unlikely that purchases of "qualified property" as specified would result in sales or use tax being paid more than once on a purchase because purchases delivered outside of the purchasing jurisdiction generally would not be subject to the purchasing jurisdiction's sales tax. Additionally, many states exempt manufacturing machinery and equipment from sales or use tax. The author may wish to consider exempting "qualified property" as specified in this bill from sales and use tax as an alternative to allowing a franchise or income tax credit.

This bill would allow taxpayers in certain circumstances to claim multiple tax benefits for the same item of expense. This bill would allow a credit for sales and use tax that is currently deductible as a business expense. Generally, a credit is allowed in lieu of a deduction in order to eliminate multiple tax benefits for the same item of expense.

This bill fails to limit the amount of the credit that may be taken. Credits that could potentially be quite costly are sometimes limited either on a per-project or per-taxpayer basis.

Generally the economic development area credits can only offset the tax on income attributable to activity within the economic development area. This bill would allow the credit to offset tax on income attributable to activity outside of the specified economic development areas, which would be unprecedented.

LEGISLATIVE STAFF CONTACT

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